



February 2001 Version

Draft Check Truncation Act

SECTION 1. SHORT TITLE.

This Act may be cited as the "Check Truncation Act."

SECTION 2. DEFINITIONS.

(a) Account means any asset or credit account with a bank on which the account-holder may write checks.

(b) Bank means-

- (1) Any person, located in a State, engaged in the business of banking;
- (2) A Federal Reserve Bank;
- (3) A Federal Home Loan Bank; and
- (4) To the extent it acts as a paying bank, the U.S. Treasury, the U.S. Postal Service, or a State or local government.

(c) Banking day means that part of any business day on which an office of a bank is open to the public for carrying on substantially all of its banking functions.

(d) Business day means a calendar day other than a Saturday or a Sunday, January 1, the third Monday in January, the third Monday in February, the last Monday in May, July 4, the first Monday in September, the second Monday in October, November 11, the fourth Thursday in November, or December 25. If January 1, July 4, November 11, or December 25 fall on a Sunday, the next Monday is not a business day.

(e) Check means a demand draft, drawn on or payable through or at an office of a bank, that is handled for forward collection or return, including an original check, an electronic check, and a substitute check. Check does not include a noncash item or an item payable in a medium other than United States money.

(f) Collecting bank means a bank that handles a check for collection, except the paying bank.

(g) Consumer means a customer who-

- (1) With respect to a check handled for forward collection, draws a check on an account used primarily for personal, family, or household purposes; or
- (2) With respect to a check handled for return, deposits the check into an account used primarily for personal, family, or household purposes.

(h) Customer means the person who draws a check, with respect to a check handled for

forward collection, or the person who deposits a check, with respect to a check handled for return.

(i) Depository bank means the first bank to which a check is transferred, even if it is also the paying bank or the payee. A check deposited in an account is deemed to be transferred to the bank holding the account into which the check is deposited, even though the check is physically received and indorsed first by another bank.

(j) Electronic check is a digitized reproduction of an original check or a substitute check.

(k) Electronic check agreement means an agreement between or among two or more persons to send or receive an electronic check in place of the original or a substitute check.

(l) Indemnifying bank means a bank that provides an indemnity under section 8 of this Act.

(m) MICR (magnetic ink character recognition) line means the numbers, which may include the bank routing number, account number, check number, check amount, and other information printed near the bottom of a check in magnetic ink in accordance with generally applicable industry standards.

(n) Noncash item means an item that would otherwise be a check, except that-

- (1) A passbook, certificate, or other document is attached;
- (2) It is accompanied by special instructions, such as a request for special advice of payment or dishonor;
- (3) It consists of more than a single thickness of paper, except a check that qualifies for handling by automated check processing equipment; or
- (4) It has not been encoded in magnetic ink with the routing number of the paying bank.

(o) Paying bank means-

- (1) The bank by which a check is payable, unless the check is payable at or through another bank and is sent to the other bank for payment or collection;
- (2) The bank at which a check is payable and to which it is sent for payment or collection; or
- (3) The bank through which a check is payable and to which it is sent for payment or collection.

(p) Person means a natural person, corporation, unincorporated company, partnership, government unit or instrumentality, trust, or any other entity or organization.

(q) Presenting bank means a bank that presents a check for payment, except the paying bank.

(r) Returning bank means a bank handling a returned check or notice in lieu of return, except the paying bank or the depository bank.

(s) Substitute check means a paper reproduction of an electronic check.

(t) State means a State of the United States, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, or a territory, possession, or dependency of the United States.

(u) Truncating bank means the bank that creates an electronic check from the original check or the first bank to which such an electronic check is transferred. If an original check is converted to an electronic check and then to a substitute check before it is transferred to a bank, then the first bank to which the substitute check is transferred is the truncating bank.

(v) Uniform Commercial Code or U.C.C. means the Uniform Commercial Code in effect in a state.

(w) Unless the context requires otherwise, the terms not defined in this section have the meanings set forth in the U.C.C.

SECTION 3. VARIATION BY AGREEMENT.

(a) Agreements. The provisions of this Act may be varied by agreement, subject to paragraph (b) of this section.

(b) Limitations on agreements. An agreement may not bind or affect the rights of persons who are not party to the agreement with respect to the provisions of this Act. A bank may not disclaim, with respect to consumers, its warranties under sections 5 and 7 or its duty to indemnify under section 8. A bank may not vary the terms of sections 9 (Expedited Recredit Procedures for Consumers), 11 (Measure of Damages), or 12 (Statute of Limitations and Notice of Claim) to reduce the rights of a consumer.

[ECCHO has suggested that the act not apply to checks truncated under programs where the banks involved have agreed to truncate/image checks under another framework, such as the ECCHO rules. As the draft indemnity and the expedited recredit provisions apply only when a substitute check is presented, why would a clearinghouse prefer not to have checks covered by this statute, given the legal equivalence that it would provide for electronic checks?]

[When Congress has adopted customer protections for payment transactions (e.g., credit cards, electronic payments), it generally has limited those statutory protections to consumer accounts. The draft law takes the same approach. While we recognize that some small businesses may benefit from similar protections, it is very difficult to draw a bright line between small and large businesses.]

SECTION 4. ELECTRONIC CHECKS.

(a) Agreement required. A person may not deposit, present, or send for collection or return an electronic check without having an electronic check agreement, subject to the limitations of section 3(b), with the recipient.

(b) Legal equivalence. An electronic check is the legal equivalent of the original check

for all purposes, including federal and state law, and for all persons, including those that are not parties to an electronic check agreement, if it-

- (1) Is subject to an electronic check agreement that meets the requirements of section 3;
- (2) Accurately represents all of the information on the front and back of the paper check at the time of conversion;
- (3) Is viewable as an image of the paper check;
- (4) Can be converted into a substitute check; and
- (5) Conforms with generally applicable industry standards for electronic checks.

[Accompanying report language should note that, at least initially, generally applicable industry standards for electronic checks will likely not require an electronic check to reflect (i) color, (ii) background designs, or (iii) texture, pen pressure, and similar nontextual information that cannot readily be captured by an electronic representation. Additionally, report language could clarify that "legal equivalence" includes, among other things, the ability to use the electronic check as proof of payment (consistent with the provisions of E-SIGN.)]

(c) Applicable law. An electronic check that is the legal equivalent of the original check under paragraph (b) of this section shall be subject to all applicable federal or state law as if it were the original check, to the extent such law is not inconsistent with this Act.

(d) Indorsements. Each bank that transfers or presents an electronic check must include its indorsement with the electronic check in accordance with generally applicable industry standards. A bank that indorses an electronic check in accordance with this paragraph is considered to have indorsed the electronic check for purposes of all other applicable federal or state law.

[If an electronic check is created from a paper check that has been handled in a carrier envelope, can the indorsements on the carrier envelope be carried through with the electronic check?]

(e) Truncating bank identifier. A truncating bank shall identify itself on the electronic check as the truncating bank in accordance with generally applicable industry standards.

[Is it technologically feasible for the truncating bank to identify itself on the check? Specifically, can a bank distinguish between original checks and substitute checks it is converting from paper to electronic form? A truncating bank identifier would make it easier for those who wanted to make an indemnity claim directly on the truncating bank rather than

going back up the collection or return chain.]

(f) Reason for return. If a paying bank returns an electronic check, it must include the reason for return as part of the electronic check, in accordance with generally applicable industry standards.

SECTION 5. ELECTRONIC CHECK WARRANTIES.

A bank that transfers or presents an electronic check and receives consideration for it warrants to the transferee, any subsequent collecting or returning bank, the drawee, the drawer, the depositary bank, the payee, and any indorser that-

(a) The electronic check meets all the requirements for legal equivalence under section 4(b); and

(b) No depositary bank, paying bank, drawer, or indorser will receive presentment or return of the electronic check, a copy or other paper or electronic version of the electronic check, or the original check, such that it will be asked to make a payment based on a check it has already paid.

SECTION 6. SUBSTITUTE CHECKS.

(a) No agreement required. A person may deposit, present, or send for collection or return a substitute check without an agreement with the recipient, so long as a bank has made the substitute check warranties in section 7 to the recipient with respect to that check.

(b) Legal equivalence. A substitute check is the legal equivalent of the original check for all purposes, including federal and state law, and for all persons if it-

(1) Accurately and legibly represents all of the information required of an electronic check under section 4(b)(2);

(2) Meets the indorsement requirements of paragraph (c) [and contains the identification of the truncating bank] and, if applicable, the reason for return;

(3) Is an image of the front and back of the original check that bears a MICR line containing all the information encoded on the original check when converted to an electronic check;

(4) Bears the legend: "This is a legal copy of your check. You can use it the same way you would use the original check."; and

(5) Conforms, in paper stock, dimension, and otherwise, with generally applicable industry standards for substitute checks.

[Is there a shorter or clearer way to state the legend?] [As with electronic checks, report language could clarify that "legal equivalence" includes, among other things, the ability to use the substitute check as proof of payment.]

(c) Indorsements. (1) General rule. To be the legal equivalent of the original check under paragraph (b), a substitute check must contain all indorsements supplied subsequent to the creation of the electronic check, unless paragraph (c)(2) applies.

(2) Special rule for redeposited checks. A substitute check that is redeposited after it has been returned (either in paper or electronic form) by the paying bank may be the legal equivalent of the original check under paragraph (b) even if it does not contain the indorsements of the depository, collecting, paying, or returning banks that previously handled the check (whether in paper or electronic form) for collection or return.

[Is this special rule for redeposited checks appropriate? The rule would enable the depository bank, upon redeposit, to strip all prior bank indorsements from substitute check resulting in a "cleaner" back. Payee and other non-bank indorsements would have to be retained. Is there ever a need for the indorsements of the banks in the prior collection and return chain? Note that the identification of the original truncating bank would have to be retained (assuming the Act requires that identification).]

(d) Applicable law. A substitute check that is the legal equivalent of the original check under paragraph (b) of this section shall be subject to all other applicable federal or state law as if it were the original check, to the extent such law is not inconsistent with this Act.

SECTION 7. SUBSTITUTE CHECK WARRANTIES.

A bank that transfers or presents a substitute check and receives consideration for it warrants to the transferee, any subsequent collecting or returning bank, the drawee, the drawer, the depository bank, the payee, and any indorser that-

(a) The substitute check meets all the requirements for legal equivalence under section 6(b); and

(b) No depository bank, paying bank, drawer, or indorser will receive presentment or return of the substitute check, a copy or other paper or electronic version of the substitute check, or the original check such that it will be asked to make a payment based on a check it has already paid.

SECTION 8. INDEMNITY.

(a) Indemnity. The truncating bank and each bank that subsequently transfers or presents the check in electronic or paper form and receives consideration for the check shall indemnify (for an amount determined under paragraphs (b) and (c) of this section) the

transferee, any subsequent collecting or returning bank, the drawee, the drawer, the depository bank, the payee, and any indorser to the extent of any loss incurred by a recipient of a substitute check, if that loss is due to the receipt of a substitute check instead of the original check.

(b) Indemnity amount. The amount of the indemnity under paragraph (a) shall be the amount of any loss proximately caused by a breach of a warranty provided under section 7 if that loss would not have occurred had the original check been transferred or presented. In the absence of a breach of a warranty provided under section 7, the amount of the indemnity shall be the amount of any loss, up to the amount of the check plus expenses and interest, if that loss would not have occurred had the original check been transferred or presented.

(c) Comparative negligence. If a loss described in paragraph (a) results in whole or in part from the negligence or failure to act in good faith on the part of an indemnified party, then that party's indemnification under this section shall be reduced in proportion to the amount of negligence or bad faith attributable to that party.

[This draft generally limits the indemnity to the amount of the check plus expenses and interest. However, the truncating bank would be liable for consequential damages in situations where it breaches the warranties provided under section 7 and the damages would not have occurred had the original check been transferred or presented. It is expected that this truncating bank liability for consequential damages would arise in relatively few situations. Generally, existing check warranty damages provisions in the U.C.C. do not provide for consequential damages. Limiting the damages to the amount of the check, plus expenses and interest, makes it easier for indemnifying banks to ascertain their potential liability when deciding how long to retain originals. On the other hand, including consequential damages would be in keeping with the overall goal of holding harmless banks and customers who have received substitute checks without agreement to do so. Report language to clarify that the standard of "loss proximately caused by a breach of a warranty provided under section 7" is to be interpreted consistent with the "proximately caused" standard of UCC § 4-402(b) (1990 Official Text).]

(d) Effect of producing original check. If the indemnifying bank produces the original check, it has a right to a return of any funds it has paid under the indemnification in excess of losses incurred up to that time that are covered by the indemnity. Production of the original check does not absolve the indemnifying bank from any liability on a warranty that it has given under this Act or other law.

[Should this paragraph be expanded to give the truncating bank a right to return of the funds under the indemnity if it produces a good image of the original, in situations where a good image would support the charge to the drawer's account or the warranty claim?]

SECTION 9. EXPEDITED RECREDIT PROCEDURES FOR CONSUMERS.

(a) When a consumer may make a claim. (1) Except as provided in paragraph (d), a consumer may make a claim against the bank that holds the consumer's account and receive expedited recredit if--

(i) The bank debited the consumer's account for a substitute check that cannot be properly charged to that account or for which the consumer has a warranty claim;

(ii) The consumer suffered a resulting loss; and

(iii) The original check is necessary to determine the validity of the charge to the consumer's account or the warranty claim.

(2) The consumer must submit the claim to the bank within 60 days after the relevant statement or check is made available to the consumer.

(3) The consumer may make a claim against a previous indemnifying bank instead of the account-holding bank, but in that case the consumer would not be entitled to expedited recredit under this section.

(b) How to make a claim. (1) To make a claim under paragraph (a) of this section, the consumer must provide to the bank--

(i) A description of the claim, including an explanation of why the check was not properly charged to the account or of the warranty claim;

(ii) A statement that the consumer suffered a loss and the amount of the loss;

(iii) A demand that the original check be produced in order to determine the validity of the charge to the consumer's account or the warranty claim; and

(iv) Sufficient information to identify the check and to investigate the claim.

(2) The bank may require the consumer's claim to be in writing.

[Accompanying report language should note that the consumer does not have to prove his/her case before making a claim, but if the bank refuses to recredit the consumer and the check is properly payable from the account, then the bank is not liable under the Act.]

(c) Recredit to consumer. If the consumer makes a claim against the bank that debited the consumer's account, then that bank must either produce the original check and show that the check was properly debited from the account or recredit the consumer's account for the

amount of the claim, up to the amount of the check or \$5,000, whichever is less, no later than the business day following the banking day the consumer makes the claim. The bank must credit the consumer's account for the remainder of the amount of the claim, plus expenses and interest, on the business day following the banking day on which the bank determines that the consumer's claim is valid, but no later than 10 business days following the banking day the consumer makes the claim. Providing a recredit does not absolve the bank from liability for wrongful dishonor under the U.C.C. or other law. The bank may reverse the recredit to the consumer's account when it provides the original check to its consumer, if the check was properly debited from the account.

[The \$5,000 recredit limit is intended to strike a balance between protecting consumers from problems associated with substitute checks and protecting banks from fraud risks associated with those checks. The accompanying report language should indicate that the funds recredited to consumers must be available for immediate withdrawal.]

(d) Exclusion for checks covered by Truth in Lending Act. This section and section 10 do not apply to a check that is subject to the error resolution procedures in Chapter 4 of the Truth in Lending Act (15 U.S.C. 1666 et seq.).

SECTION 10. EXPEDITED RECREDIT PROCEDURES FOR BANKS.

(a) When a bank may make a claim. Except as provided in section 9(d), a bank may make a claim against an indemnifying bank and receive expedited recredit if--

(1) (i) A consumer claims that a substitute check cannot be properly charged to the consumer's account at that bank or otherwise asserts an indemnity or warranty claim related to a substitute check; or

(ii) The claimant bank wishes to assert an indemnity or warranty claim related to a substitute check;

(2) The claimant bank has suffered a resulting loss; and

(3) The original check is necessary to determine the validity of the charge to the consumer's account or the warranty claim.

(4) The bank must submit the claim to the indemnifying bank within 120 days after the date of the transaction that gave rise to the claim.

[The 120-day period is intended to allow time for the consumer to make a claim (generally, 60 days after receiving the account statement, which may be as long as 30 days following the transaction date) plus time for the claim to pass through other preceding banks in the collection or return chain.]

(b) How to make a claim. To make a claim under paragraph (a) of this section, the bank must provide to the indemnifying bank-

(1) A description of the claim, including an explanation of why the check was not properly charged to the consumer's account or of the warranty claim;

(2) A statement that it has suffered a loss due to the charge or warranty claim and the amount of the loss up to the amount of the check, plus interest and expenses;

[As drafted, the indemnity would cover consequential damages for losses due to warranty breaches. Should the expedited recredit procedures provide a mechanism to cover those consequential damages or be limited to the amount of the check plus interest and expenses?]

(3) A statement that the original check is necessary to determine the validity of the debit to the consumer's account or the warranty claim; and

(4) Sufficient information for the indemnifying bank to identify the check and to investigate the claim. This information may include, for example, a copy of the check or checks at issue. Any copies must be clearly labeled as copies so that they cannot be mistaken for the legal equivalent of the check. These copies must not be sent or handled as returned checks. At the request of the indemnifying bank, the claimant bank must provide a copy of the consumer's claim, if any.

(c) Recredit by indemnifying bank. No later than 10 business days after receiving the notice, the indemnifying bank must either produce the original check or recredit the indemnified bank for the amount of the claim, up to the amount of the check, plus interest. If the indemnifying bank produces the check after the 10 days has elapsed, it has a right to a refund of any amount it had previously credited to the indemnified bank in excess of any losses incurred up to that time that are covered by the indemnity. The indemnifying bank may recover from any indemnified party if the charge to the consumer's account is appropriate or the warranty claim is without merit for reasons that do not depend on the absence of the original check.

(d) Subrogation of rights. An indemnifying bank that provides a recredit under paragraph (c) may attempt to recover from another party based on a warranty or other claim. Each indemnifying bank is subrogated to the rights of any indemnified party to the extent of the indemnity. Each indemnified party has a duty to comply with all reasonable requests for assistance from the indemnifying bank in connection with any warranty claim the indemnifying bank brings against a warrantor.

SECTION 11. MEASURE OF DAMAGES.

Except as provided in section 8, damages for breach of warranty or failure to provide recredit under this Act shall be an amount equal to the loss suffered as a result of the breach or

failure, but not more than the amount of the check or checks in question, plus interest and expenses, including costs and attorney's fees related to the check. Damages, if any, are reduced by the amount, if any, that the claimant receives and retains as a recredit.

SECTION 12. STATUTE OF LIMITATIONS AND NOTICE OF CLAIM.

(a) Statute of limitations. Any indemnity claim under this Act must be made within three years after the claimant has settled for the check or checks in question, by account debit or otherwise. An action to enforce a warranty claim under this Act may be brought in any United States district court, or in any other court of competent jurisdiction, and shall be brought within three years after the cause of action accrues.

[Are these time limits appropriate? (See the general 3-year limit in UCC 4-111, the one-year and other limits for examining statements in UCC 4-406, and the one-year limit in Regulation CC § 229.38(g).) Deferring to the UCC without setting specific time limits raises ambiguities regarding the statute of limitations where this Act provides warranties or other rights that do not exist in the UCC.]

(b) Notice of claim. Unless a claimant gives notice of an indemnity claim to the indemnifying bank within 30 days after the claimant has reason to know of the claim and the identity of the indemnifying bank, the indemnifying bank is discharged to the extent of any loss caused by the delay in giving notice of the claim.

SECTION 13. EFFECT ON OTHER LAW.

This Act shall supersede any provision of Federal or State law, including the Uniform Commercial Code, that is inconsistent with this Act.

SECTION 14. EFFECTIVE DATE.

This Act is effective on the later of January 1, 2003, or one year after the date of enactment.

[The effective date would be set with enough lead time (1) for the industry to establish the necessary standards for electronic image exchange (does an effective date of January 1, 2003, allow enough lead time or would an earlier or later date be more appropriate?) and (2) for banks and others to train their staff and make any other necessary changes to accommodate the potential receipt of substitute checks (would one year after enactment be sufficient?)]

[Additional issue: Are there interpretive or other issues that should be included in the statutory text or in report language? Should the Board or

other agency have regulatory or interpretive authority?]
